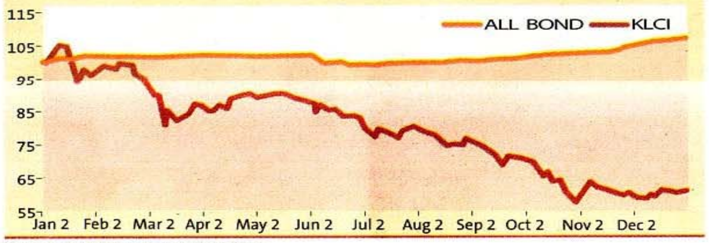
Bond market deserves coverage

It will be valuable to investors, bond issuers and policy makers

By MEOR AMRI MEOR AYOB

All-Bond Index versus KLCI throughout 2008 (same scale)



Source: BPA Malaysia & SIX Telekurs

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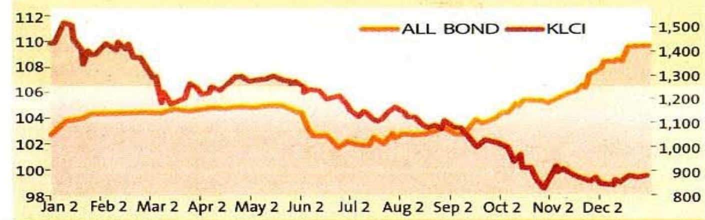
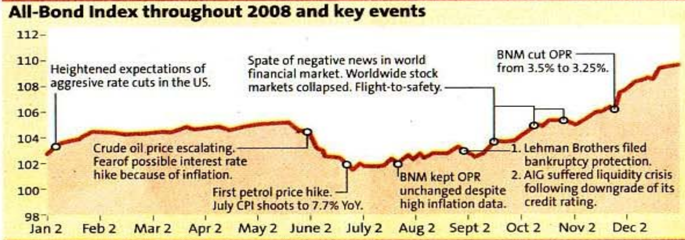


Source: BPA Malaysia & SIX Telekurs;
Note: Left Y-axis refers to FiiX – All Bond Index; right Y-axis refer to KLCI

All-Bond Index throughout 2008 and key events



Source: BPA Malaysia

Malaysia's bond market can be characterised as being in a developmental phase. High growth rates have been its hallmark, attributable to increasing recognition of the local bond market as a viable alternative for capital formation.

Borrowers can exert substantial influence over the structure of a proposed bond issue; coupled with the vast number of potential investors with varying risk appetites, this has effectively fuelled growth.

The push by financial institutions to reprioritise lending activities to the retail sector after the regional crisis of the late 1990s has also accelerated market disintermediation, with corporate borrowers moving away from the banking sector to the bond market.

The regulatory push to mould Malaysia into a global hub for the development of Islamic finance is also an important plus-point for the domestic bond market.

On the supply side, the issuance of *sukuk* in terms of innovation and volume has been well matched by growth on the demand side.

The issuance of new licences for Islamic financial institutions and the rising number of dedicated *sukuk* funds all point to a bright future for Malaysia's bond market.

Over the past four years, Malaysia's bond market has been enjoying healthy annual growth rates.

The *sukuk* market boasts even stronger growth during that period. As a result, *sukuk* now constitutes 36.2% of the entire Malaysian bond market, compared with 28.9% in 2005.

Malaysia's equities market is extensively covered by research houses. The performance of the KL Composite Index (KLCI), which tracks the price movements of a core group of listed companies that represent major economic sectors, is one of the key barometers of the health of the domestic financial system.

As at Dec 31, 2008 the domestic equities market was valued at RM663.8bil while the bond market was worth RM583.8bil.

Although the latter is slightly smaller than the former in terms of size, the economic value it represents warrants a similar level of coverage, which unfortunately is absent.

Lack of information has been cited as the key barrier for analysts and researchers.

On Dec 19, 2008 Bond Pricing Agency Malaysia Sdn Bhd (BPA Malaysia) launched a new service which provides an innovative form of information on the domestic bond market.

In this regard, the BPA Bond Index SeriesTM aims to highlight the historical performance of Malaysia's bond market, not just through a single index but a series of indices that highlight different segments of the domestic market.

This series allows users to choose any index, based on the principle (all: conventional or Islamic), index type (all: government, quasi-government, Bank Negara, financial, corporate guarantee, corporate or asset-backed securities) and tenure (all: three months to one year, one to three years, three to seven years, or more than seven years). Therefore, the series allows a possible permutation of 120 indices on just Malaysia's bond market.

Each index in the series starts with the prefix FiiXTM.

This series is aimed at providing guidance for gauging performance, barometers on market movements and data to compute the accuracy as well as timeliness of an asset, or the general market's risk-return characteristics.

Similar to Malaysia's equities market, international events also have a direct bearing on the movements of the domestic bond market. Using the FiiXTM – All-Bond Index as a market barometer, supply and demand respond accordingly to events throughout the world.

Positive news such as rate cuts, even if not directly related to local interest rates, have a direct influence on the performance of Malaysia's bond market.

Even expectations of aggressive rate cuts in the United States can lift the price performance of local bonds.

At the other extreme, escalating prices of crude oil and the collapse of revered financial institutions such as Lehman Brothers and American International Group (AIG), among others, cause local bond prices to retreat.

Of course, such events have also had an effect on the equities market.

If we refer and compare the FiiXTM – All-Bond Index to the KLCI, we may observe an interesting pattern. It is clear that the FiiXTM – All-Bond Index has a negative correlation with the KLCI, based purely on their opposing directions in 2008.

The equity market (as embodied by the KLCI) was affected much more by the negative events in 2008.

In fact, the KLCI posted an annual return of minus 38.9%.

On the contrary, the bond market (as represented by the FiiXTM – All-Bond Index) reported a positive annual return of 6.7%.

The statistics confirm the theory that the behaviour of Malaysia's bonds and equities markets is similar to that experienced in developed economies.

This essentially means that portfolio managers that are not limited to a particular class of assets (i.e. they can invest in bonds as well as equities) can switch assets when one market becomes bearish.

Islamic Sukuk

Meanwhile, *sukuk* as a viable capital-raising instrument is gaining momentum. Market participants have been increasing their focus and resources in this particular area. Given the level of interest in this asset class, it would be interesting to note its risk-reward characteristics.

The FiiXTM – Conventional Government Bond Index and FiiXTM – Islamic Government Bond Index moved in tandem before June and after October 2008, more or less at the same pace.

However, the movements of these two types of bonds deviated during the time of the steeper market downturn between June and October 2008. As such, it can be observed that conventional sovereign papers lost more ground than *sukuk*, despite the fact that the papers are issued by the same entity.

This gap between the two indices is more noticeable during that particularly volatile period.

The positive gap (advantage to sovereign *sukuk*) during a market downturn seems to imply that *sukuk* assets (all else remaining equal) are more stable and resilient during times of stress.

Nonetheless, more research will have to be undertaken to confirm this hypothesis. Additional research resources should be deployed towards the local bond market, as results from such studies can help portfolio managers maximise returns. Taking advantage of trends such as the market's movements or risk return characteristics can only be done if an information database is available.

It will not only be valuable to the investing community, but also to bond issuers, product-development specialists and policymakers. Also, market inefficiency can be easily identified and directly addressed.

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